

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

Number: **200727014**

Release Date: 7/6/2007

CC:ITA:B07:  
POSTF-152391-06

UILC: 471.01-00, 263A.03-02

date: February 09, 2007

to: Connie S. Fish  
Team Manager  
(LMSB:FS:1192)

from: Grant D. Anderson  
Senior Counsel, Branch 7  
(Income Tax & Accounting)

---

subject: Capitalization of costs of X publishers under § 263A

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

X =

Y =

ISSUES

1. Is the taxpayer required to use inventories to account for X that it publishes under § 471 of the Internal Revenue Code?
2. Is the publication of X a production activity under § 263A?
3. Are book publication costs incurred by the taxpayer in publishing X required to be capitalized to inventory under § 263A?

CONCLUSIONS

1. The taxpayer is required under § 471 to use inventories to account for X it publishes.

2. The publication of X is a production activity under § 263A.
3. Book publication costs incurred by the taxpayer in publishing X are required to be capitalized to inventory under § 263A.

### FACTS

The taxpayer produces, publishes and distributes X. Revenue is generated from selling advertising space in the X. The taxpayer consults on the best type and the placement of the advertisements. It also helps design and create the advertisements. The taxpayer's business cycle for each X is generally 15-20 months. The taxpayer begins soliciting advertising contracts approximately 6-8 months prior to publication of the X. Approximately 2 months prior to publication the production and printing stage occurs. Finally, the X is distributed to Y subscribers at no charge to them, in the geographic area covered by the X. A X generally has a 12 month life.

A contract is entered into with a customer for an advertisement to be placed in a X scheduled to be published by the taxpayer. For financial accounting purposes, the transaction is not recorded until the date of publication, when the full value of the contracts written for the X is recorded as deferred revenue. Customers are billed and revenue is recognized ratably over the life of the X (generally a 12 month period). The costs incurred related to the publication of the X are capitalized and deferred until the date of publication, and are then amortized over the life of the book (generally 12 months). These publication costs include sales commissions, production, printing, paper, and delivery.

For tax purposes, the taxpayer recognizes income when the selling price is billed to the customer, generally, over the 12 month life of the X. The related publication costs are deducted as incurred, which is generally prior to publication.

### LAW AND ANALYSIS

1. Is the taxpayer required under § 471 to use inventories to account for X that it publishes?

Section 471(a) requires the use of inventories whenever inventories are necessary in order clearly to determine the income of the taxpayer. Inventories are to be taken on the basis the Secretary prescribes so as to conform as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-1 of the Income Tax Regulations specifies that in order to reflect taxable income correctly, inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

Section 471 and the regulations thereunder require the use of inventories whenever the production, purchase, or sale of merchandise is an income-producing factor. The term "merchandise" is not defined in the Code or regulations. However, in *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970), aff'g T.C. Memo. 1969-39, the First Circuit, after reviewing the relevant authorities, defined "merchandise" as personal property held for sale. Following *Wilkinson-Beane*, other courts have recognized that merchandise generally is goods held for sale. See, e.g., *Thompson Electric, Inc. v. Commissioner*, T.C. Memo. 1995-292; *J.P. Sheahan and Assoc. v. Commissioner*, T.C. Memo. 1992-239. The term "sale" has been defined as "[a] revenue transaction where goods or services are delivered to a customer in return for cash or a contractual obligation to pay. [The] [t]erm comprehends transfer of property from one party to another for valuable recompense." Black's Law Dictionary, 6th ed., p. 1337 (West Publishing 1990). See U.C.C. § 2-106(1) (1990) ("A 'sale' consists in the passing of title from the seller to the buyer for a price.").

We believe that § 1.471-1 should be broadly interpreted and that a sale of merchandise for purposes of § 1.471-1 includes any exchange of tangible personal property for payment. The term is not limited to a transfer of property between a single seller and a single buyer. Thus, the term "sale" is broad enough to encompass a transaction wherein the payment for the sale of advertising space in a X is received from the purchaser and the X is delivered to the purchaser's potential customers. The reason why the taxpayer can give the X to the Y subscribers without charge is because the profit from the transfer of the merchandise is derived through the sale of the advertising space. The effect is the same as if the advertisers were buying the X and having them distributed by the taxpayer to potential customers. The need for a taxpayer to use inventories is not affected by the fact that the taxpayer's revenues are primarily received from entities other than those who receive the taxpayer's merchandise. See, for example, *Knight-Ridder Newspaper, Inc. v. United States*, 743 F.2d 781, 790 (11th Cir. 1984), Rev. Rul. 81-272, 1981-2 C.B. 116 (situation 5). Thus, the X containing the advertising space sold to the taxpayer's customer but delivered to the purchaser's potential customers are held for sale by the taxpayer and are merchandise for the purposes of § 1.471-1.

In addition, § 1.471-1 does not specifically limit the requirement to use inventories to when the sale of merchandise is an income-producing factor. The use of inventories is also required whenever the production of merchandise is an income-producing factor. Here, the taxpayer publishes X and earns revenue by selling advertising space in the X. Although the taxpayer's revenue is nominally derived from the sale of the advertising space, the production, publishing and distribution of the X is an intrinsic and indispensable part of the sale of the advertising space. Without producing the X, the taxpayer could not realize income from the sale of the advertising space in the X. Thus, the production of the X is an income-producing factor for the purposes of § 1.471-1. As a result, under § 471 and the regulations thereunder, inventories are necessary in order clearly to determine the income of the taxpayer.

2. Is the publication of X a production activity under § 263A?

Section 1.263A-1(a)(3) provides that, under § 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to tangible personal property produced by the taxpayer.

Section 263A(b) provides that tangible personal property includes a film, sound recording, video tape, book, or similar property. See also § 1.263A-2(a)(2)

Section 263A(g)(1) defines the term "produce" to include construct, build, install, manufacture, develop, or improve. See also § 1.263A-2(a)(1).

Section 263A of the Code and the regulations thereunder provide uniform rules for capitalization of costs properly allocable to property produced by a taxpayer. Under those rules, the taxpayer is producing property within the meaning of § 263A when it publishes its X. The X are tangible personal property and the taxpayer creates them. Sections 263A(b) and (g)(1). There is no specific exemption listed in either the Code or the regulations that exempts book publishers, such as the taxpayer, from having to capitalize costs under § 263A. Accordingly, the taxpayer is required to capitalize the direct costs and indirect costs that directly benefit or are incurred by reason of the production of the X.

3. Are book publication costs incurred by the taxpayer in the production of X indirect costs required to be capitalized to inventory under § 263A?

Section 263A(a) provides that the direct and indirect costs properly allocable to property that is inventory in the hands of the taxpayer are included in inventory costs.

Section 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. Once costs are allocated to production activities, the costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(e)(2)(i) provides that producers must capitalize direct material costs and direct labor costs. Under § 1.263A-1(e)(2)(i)(A) direct material costs include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. Under § 1.263A-1(e)(2)(i)(B) direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced.

Section 1.263A-1(e)(3)(i) provides, in part, that indirect costs are defined as all costs other than direct material costs and direct labor costs and are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(e)(3)(iii)(A) lists selling and distribution costs as examples of indirect costs are not required to be capitalized under § 263A. These costs are

described as marketing, selling, advertising, and distribution costs. See also § 1.263-3(C)(4)(IV)(A).

Section 1.263A-2(a)(3)(i) provides that, generally, producers must capitalize direct and indirect costs properly allocable to property produced under § 263A, without regard to whether those costs are incurred before, during, or after production.

The taxpayer is producing tangible personal property within the meaning of § 263A when it publishes its X. See §§ 263A(b) and (g)(1), 1.263A-2(a)(1) and 1.263A-2(a)(2). Therefore, the taxpayer is required to capitalize all direct material costs, direct labor costs, and indirect costs properly allocable to its X. See §§ 1.263A-1(e)(2)(i) and 1.263A-1(e)(3). Among the costs incurred by the taxpayer are those related to the publication of its X (book publication costs). These costs are sales commissions, production, printing, paper, and delivery costs. Whether any of the taxpayer's book publication costs are capitalizable depends on whether, under all the facts and circumstances, the particular cost is properly allocable to the taxpayer's production activities under § 1.263-1(c)(1).

Book publishers sell a printed product. It begins with an idea which is transformed by some combination of processes to a completed printed product which could be in the form of a business card, a book, a calendar, a poster, or other item. See Market Segment Specialization Program Guideline, Commercial Printing, (April 1997) 1997 WL 1138080 (I.R.S.) Inventory for a printing company usually includes materials such as film, plates, chemicals, typesetting film, masking sheets, paper, envelopes, ink and glue. The paper and printing costs incurred by the taxpayer are usually direct materials, since they become an integral part of specific property produced, or direct labor since they can be identified or associated with particular units or groups of units of property produced. See § 1.263A-1(e)(2)(i)(A). Likewise, the costs identified as production costs usually would include direct materials and direct labor as well as those indirect costs that are allocable to the property being produced, and would be capitalizable. See §§ 1.263A-1(e)(2)(i) and 1.263A-1(e)(3). In contrast, under § 1.263A-1(e)(3)(iii)(A), delivery costs that are distribution costs would not be capitalizable. Similarly, costs described as sales commissions usually would be incurred in selling the taxpayer's finished products and, as a selling expense, would not be capitalizable under § 1.263A-1(e)(3)(iii)(A). However, in this case, because of the nature of the taxpayer's production activities, the sales commissions are capitalizable as production labor costs.

The question of capitalization under § 263A does not turn on how costs are labeled. Rather, the principle focus should be on whether the costs directly benefit or are incurred by reason of a production activity or a selling or distribution activity. The answer depends on the activity for which the commission was paid; is the employee engaged in selling and distribution activities or production activities.

As discussed above, the sale of advertising space in a X obligates the taxpayer to provide advertising space in the X and to deliver the X to the Y subscribers, the potential customers of the purchaser. However, the primary thrust of the employee's activity is to generate an advertisement for inclusion in the X. As much as the paper and ink, the advertisements are raw materials used in the production of the X. In

essence, the advertising sales commissions are not incurred to sell or distribute a finished product to a customer, but to acquire the material needed to produce the product. Thus, under § 1.263A-1(c)(1), the sales commissions are properly allocable to the taxpayer's production activities and are capitalizable to the inventory produced during the taxable year the costs are incurred. Further, if the commissions can be identified or associated with particular units of specific X produced, the costs would be properly capitalizable as direct labor costs under § 1.263A-1(e)(2)(i)(B). If the commissions cannot be so identified or associated with a specific X, the advertising sales commissions are properly capitalizable as indirect labor costs under § 1.263A-1(e)(3)(i).

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call \_\_\_\_\_ if you have any further questions.